

AUDITOR OF PUBLIC ACCOUNTS

2018 LOCAL GOVERNMENT FISCAL DISTRESS MODEL OVERVIEW

Summary of the Fiscal Distress Process

Chapter 836 of the 2017 Virginia Acts of Assembly directs the Auditor of Public Accounts to establish a prioritized early warning system to identify potential local fiscal distress within localities across Virginia and monitor accordingly on an annual basis. During the first year of implementation in 2017, our office used a ratio analysis, referred to as the Financial Assessment Model (FAM), to make a preliminary determination of where we would focus additional follow up with a locality that appeared to show signs of potential fiscal distress. This analysis calculated ten financial ratios for each locality resulting in an overall FAM score, which was based on an average score of the ten ratio results that were compared and ranked against all localities' ratio results. Using the FAM score results, we developed a 16 percent threshold to use as an indicator for making our preliminary determination of the need to perform further follow up with a locality based on the FAM ratio analysis. In March 2018, after completing the follow up process with the localities identified as part of the 2017 model, our office issued the [Local Government Fiscal Distress Monitoring Report](#), which described an overview of the legislative requirements for this process, background on the process and ratio analysis that our office implemented during 2017 to initially develop an early warning monitoring system, the results of our reviews performed with specific localities identified as part of our analysis, and plans to refine our analysis to further enhance the early warning monitoring system for future years.

In 2018, the Auditor of Public Accounts revised the criteria and made changes to the model we are now using to make a preliminary determination of where our office will focus additional follow up with a locality that appears to show signs of potential fiscal distress. The new model calculates twelve financial ratios using audited financial statement data, along with considering demographic and other external factors in an additional qualitative analysis. Based on our final analysis, each locality is then qualitatively identified into one of two categories: either identified in the current year as needing further follow up through our financial assessment questionnaire review process, or identified as not needing any further follow up. Updates to the fiscal distress model and our monitoring process beginning in 2018 is further described below.

2018 Refinements to the Ratio Analysis and Early Warning System Model

During 2018, the Auditor of Public Accounts worked on several areas to improve and enhance the ratio methodology and overall approach to our fiscal distress monitoring model. First, we determined it was necessary to change how we analyze each locality's performance or results of the calculated financial ratios. In particular, we have decided no longer to use the Financial Assessment Model nor calculate a FAM score. Additionally, we are no longer using any ranking or comparison methodology when evaluating the financial ratio results for each locality. Based on feedback we received about the FAM analysis, we realized that there appeared to be a prevalent misunderstanding about the use and intent of the FAM score calculation in our analysis. As a result of this misunderstanding, some stakeholders and localities were inappropriately

applying the FAM scores; for example, using the scores to compare localities better or worse against each other or interpreting a higher FAM score to mean it was a rating of fiscal health, which were contrary to the intent of our analysis. Accordingly, for 2018 and going forward for future analysis, we will not use the FAM score percentage as the threshold to determine the need for additional follow up with a locality.

For 2018, we have revised our ratio analysis to focus on a new methodology, which primarily analyzes each locality's own ratio performance as it stands alone on an individual basis, and does not compare the ratio results from one locality to another. Again using data directly from the locality's audited annual financial report, the new methodology calculates financial ratios for each locality. Based on the performance of the ratios, the model assigns a points based, quantifiable evaluation to varying percentage levels for the ratio's performance. For example, if Ratio X indicates a weak or undesirable outcome then this ratio will receive a higher level of points. Conversely, if the outcome is a strong, desirable level of performance then Ratio X would receive no points, or if the outcome is more of a fair or adequate level of performance, Ratio X would receive an amount of points somewhere between the low and higher level. Overall, a higher number of points for each ratio, and in total for all ratios combined, indicates the locality is showing an overall weak or undesirable performance in the ratio analysis, and we will perform further qualitative analysis on those applicable localities.

In the points based evaluation, each ratio is weighted according to the ratio's relative importance that our office has internally established based on our prior year analysis, discussions with Virginia state and local professionals, research of other states' models, and our general understanding of the data and ratios for Virginia's localities. Our judgment and consideration applied to the ratio percentage levels of weak, adequate, or strong performance results is also based on our research and discussions with other states and professional groups, along with common industry benchmarks established by professionals, such as those set by bond rating agencies and in similar fiscal analysis from organizations like the International City/County Management Association.

Additionally, our office reexamined the ten ratios that were calculated as part of the 2017 FAM score model and determined there was duplicative analysis across certain ratios, and some ratios may not be the most beneficial for our analysis. In updating the model, we decided that our analysis would benefit from adding in new ratios to look at different factors. We kept five ratios from the prior ratio analysis, which we felt primarily captured some of the main issues discussed during the follow up process with the localities identified in 2017. We also added seven new ratios to our 2018 analysis, to include ratios that analyze the change in overall net position and unassigned fund balance from year to year; an operations ratio, which measures whether a locality's annual revenues were sufficient to pay for annual operations; and two ratios that examine a locality's outstanding debt level and annual debt service payments. Lastly, we added a new ratio that looks at the locality's dependency on other governmental revenues from state and federal funds, along with a ratio that examines a locality's business type, enterprise activity and whether that applicable activity is self-sufficient and self-sustaining from year to year. Refer

to [Appendix A](#) for additional information on the twelve ratios included in the updated ratio analysis of our model.

In addition to the changes made to the ratio analysis, we have updated the model to now include a qualitative assessment, which looks at demographic and other external factors as part of our final evaluation to identify a locality where we determine the need for additional follow up. This qualitative evaluation will focus on those localities we have identified in the ratio analysis as having a high number of total points for all twelve ratios. The qualitative analysis will focus on reviewing trends in demographic factors, such as growth or decline in population, median household income, and the assessed value of a locality's real estate and tangible personal property, along with reviewing whether there has been a decrease or increase in factors such as unemployment rate and poverty rate. We will also analyze how a locality compares to the national and state level averages for several of these demographic factors.

Our qualitative analysis also incorporates trends from other local government assessments, to include a locality's fiscal stress index calculated by the Virginia Commission on Local Government, and reviewing trends from the Virginia Department of Education's calculations for the Composite Index and a locality's Required Local Effort and Required Local Match, which focus on analyzing the local school divisions' ability to pay education costs that are fundamental to the Commonwealth's Standards of Quality. Lastly, this analysis will incorporate any external, economic, or other qualitative factors and information that our office is made aware of either through discussions with the locality or other state officials; from our continual review and monitoring efforts of information made public in the news or in board or council meetings; or through other information we gather from a more in depth review of the locality's audited financial report, such as management's discussion and analysis or the footnote disclosures.

For 2018, as part of the first phase of the model, we calculated the twelve financial ratios based on fiscal year 2017 audited financial statement data for the cities, counties, and towns annually required to report to our office. We then reviewed the localities showing a high number of points based on the ratio analysis. We set a threshold this year to further review those localities having a total of 30 ratio points or higher as part of our additional qualitative analysis that examines demographic and other qualitative factors. We determined a 30-point threshold as the maximum number of total points this year based on our overall review of the ratio analysis and application of professional judgment. The maximum points threshold will likely vary from year to year depending on the performance of the ratios each year, our professional judgment, and any other external factors that may impact our analysis.

[Additional Follow Up Review Process](#)

After completion of both the ratio analysis and qualitative analysis phases of the model, the Auditor of Public Accounts makes a determination of the need to perform further follow up with a locality. Based on our final analysis, each locality is identified into one of two categories: either identified as needing further follow up through our additional review process, or identified as not needing any further follow up. If a locality is identified in the current year as needing

further follow up review, we will follow the same process as in the prior year to notify the local governing body and chief executive officer of our preliminary determination. The locality must then notify our office regarding its decision to allow our additional follow up and review through completion of our financial assessment questionnaire and further discussions with our office. Once we receive a locality's completed questionnaire, we will schedule a time to meet with representatives from the locality to discuss the information provided. We may also request any pertinent documents or supplemental information to assist in our review.

A copy of the financial assessment questionnaire is available on our website, located at the Local Government Annual Guidelines, Manuals, and Other Procedural Documents. Localities not identified for further follow up review may also use the questionnaire as a self-assessment tool at their discretion.

http://www.apa.virginia.gov/data/download/local_government/guidelines/Fiscal Stress Monitoring Follow-Up Questionnaire.xlsx

Our additional follow up process focuses on qualitative factors impacting a locality's situation to gain information related to budget processes, debt, borrowing, expenses and payables, revenues and receivables, staffing, and any other external variables contributing to a locality's financial position, through use of the financial assessment questionnaire and further discussions with locality officials. The financial assessment questionnaire is a key component of our follow up process as it is designed to examine other qualitative and external factors unique to each locality that are not easily measured in a financial ratio, along with gaining an understanding of policy and procedural aspects that may contribute to the locality's results in our ratio analysis and qualitative analysis. The primary objective of our follow up with each locality identified is to determine whether a locality is experiencing a situation of fiscal distress that warrants further assistance or intervention from the Commonwealth. Upon completion of our follow up with a locality, if a situation of fiscal distress is identified, the Auditor of Public Accounts is required to formally notify, in writing, the Governor, Chairmen of House Appropriations and Senate Finance Committees (Money Committees), and the locality's governing body, concerning any specific issues identified at the locality that may require further assistance or intervention by the Commonwealth. At that point, the process is administered by the Governor's office and the Money Committees for further consideration of any plan and action by the Commonwealth to help address the locality's fiscal distress situation. Additionally, should a locality decline any further follow-up and review from our office as a result of our preliminary determination, we will notify the Governor and chairmen of the money committees accordingly.

Appendix A: Summary of New Ratios in 2018 Updated Model

The first six ratios are calculated using audited data from a locality's government wide financial statement of net position and statement of activities for all governmental and business type activities combined. The last six ratios are calculated using audited data from the governmental funds balance sheet and income statement, primarily from a locality's general fund.

Ratio 1: Unrestricted reserves net of current liabilities compared to normal revenues	• Measures the ability to make up revenue shortfalls or utilize unrestricted reserves during an unforeseen situation (<i>Government-wide Activity</i>)
Ratio 2: Unrestricted reserves compared to current liabilities	• Measures the ability to pay current liabilities without need for additional revenue (<i>Government-wide Activity</i>)
Ratio 3: Unrestricted net position compared to total expenses	• Measures ability to fund expenses in event of revenue shortfall or unforeseen situation (<i>Government-wide Activity</i>)
Ratio 4: Change in net position	• Measures how financial position has improved or deteriorated as a result of resource flow (<i>Government-wide Activity</i>)
Ratio 5: Total debt compared total valuation	• Measures total outstanding tax supported debt as a percentage of total tax valuation of real estate and personal property (<i>Government-wide Activity</i>)
Ratio 6: Business type enterprise activity self-sufficiency	• Measures whether enterprise funds are self supporting and recovering their full costs through charges for services or other revenues (<i>Government-wide Activity</i>)
Ratio 7: Unassigned plus other available fund balance reserves compared to total expenditures	• Measures ability to fund expenditures from reserves in event of a revenue shortfall or unforeseen situation (<i>General Fund Activity</i>)
Ratio 8: Total fund balance compared to total revenues	• Measures the locality's sufficiency of reserves relative to revenue (<i>General Fund Activity</i>)
Ratio 9: Total revenues compared to total expenditures	• Measures whether annual revenues were sufficient to pay for operations (<i>General Fund Activity</i>)
Ratio 10: Debt service principle and interest compared to total revenues	• Identifies the percent of the budget that is used or needed for repayment of debt (<i>General Fund and Debt Service Fund Activity, if applicable</i>)
Ratio 11: Change in unassigned fund balance	• Measures whether the unassigned fund balance has increased or declined from the prior year (<i>General Fund Activity</i>)
Ratio 12: Intergovernmental revenues compared to total operating revenues	• Measures the reliance on state and federal revenues (<i>General Fund Activity</i>)